

SEC Publishes Risk Alert with Observations from Examinations of Mutual Funds, Money Market Funds, and Target Date Funds

by Ellen J. Bickal

On November 7, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a Risk Alert highlighting the most often cited deficiencies and weaknesses observed in recent examinations of registered investment companies ("funds"), including as related to national examination initiatives focusing on money market funds and target date funds. The observations resulted from nearly 300 fund examinations over a two-year period, as well as from 70 money market fund exams and exams of 30 target date funds (the "Exams"). OCIE generally publishes its Risk Alerts when it believes that the information can assist all funds in assessing compliance risks.

According to OCIE, the most often cited deficiencies in the Exams fall into one of four categories described further below.

Fund Compliance Rule

The fund compliance rule, Rule 38a-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), requires a fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by a fund, including policies and procedures that provide for the oversight of compliance for each investment adviser, principal underwriter, administrator, and transfer agent of the fund (collectively, "Service Providers"). Additionally the compliance rule requires board approval and reporting by the chief compliance officer of the fund and annual review of the adequacy and effectiveness of policies and procedures. OCIE's observations relating to the fund compliance rule, include:

- Funds adopting compliance programs that did not take into account the nature of the funds' business (e.g., were not tailored to the business activities or risks specific to the fund). Further, OCIE staff noted procedural deficiencies in areas such as pricing and disclosures;
- Funds having policies and procedures they do not follow or enforce, including as related to instances where board approval or ratification was required but not obtained and in connection with certain brokerage practices;

Related People

- Ellen J. Bickal

Related Capabilities

- Investment Management
- Investment Funds
- Securities & Financial Services Litigation & Enforcement

- Funds not adequately supervising Service Providers and failing to adopt and implement policies and procedures to oversee compliance by their Service Providers; and
- Funds failing to conduct annual reviews of the adequacy of the funds' policies and procedures, including instances where supporting documentation was not retained.

Disclosure to Investors

Under federal securities laws it is unlawful to make untrue statements of material fact, or omit material information necessary to make other statements not misleading in registration statements, reports, and other documents filed with the SEC or provided to investors. OCIE observed funds with incomplete or potentially misleading information in their registration statements and shareholder reports as compared to the funds' actual activities. OCIE cited funds identifying principal investment strategies that the fund hadn't or did not intend to implement. OCIE observed other instances where fees paid to Service Providers were not disclosed.

Section 15(c) Process

Section 15(c) of the 1940 Act requires a majority of the fund's independent directors to approve a fund initially entering into, or renewing, a contract or agreement with an investment adviser or a principal underwriter for the fund. As part of this approval process, boards have a duty to request and evaluate information that may be reasonably necessary for the board to evaluate the terms of the contract, and to preserve records relating to the review and approval process. OCIE noted the following common deficiencies:

- Boards failing to request or consider information reasonably necessary for to evaluate the fund's investment advisory agreement, including as related to profitability of the adviser, economies of scale, or peer group comparisons and in some instances receiving incomplete information;
- Funds' shareholder reports failing to adequately discuss the material factors and conclusions that formed the basis for the board's approval of the advisory contract as required; and
- OCIE also observed recordkeeping deficiencies in the 15(c) process or instances where detailed minutes of the process were not maintained.

Fund Codes of Ethics

The code of ethics rule requires funds and certain others, to adopt a written code of ethics containing provisions reasonably necessary to prevent "access persons" from engaging in any fraudulent, deceptive, or manipulative acts in connection with the purchase and sale of securities held or to be acquired by the fund. The rule also generally requires access persons to report certain personal securities holdings and transactions to the fund. The OCIE noted deficiencies and weaknesses of the following nature:

- Funds which did not implement a code of ethics, or adopted a code of ethics lacking critical procedures, such as those relating to preventing access to or misuse of

material non-public information or failing to designate the access persons as required by the rule.

- Failures to follow or enforce the fund's code of ethics as relating to, enforcement of pre-clearance and holding periods restrictions; and
- Failure to have the board approve the code of ethics initially, and subsequently, failure to provide the fund's boards with required annual reporting detailing violations of the code of ethics and the corrective actions taken.

In addition to the four categories of deficiencies summarized about, the OCIE summarized observations from its recently conducted national examination initiatives in connection with money market funds ("MMFs") and target date funds ("TDFs"). The OCIE national examination initiatives are part of its assessment of market-wide risks and matters of importance to retail investors and investors saving for retirement.

OCIE's Money Market Fund Initiative

Following the 2016, SEC money market fund reforms, OCIE examined more than 70 MMFs to assess implementation and compliance with the amendments to the rules. The funds examined included Government, Prime, and Tax Exempt funds, as well as funds designated as Retail MMFs, which limit beneficial ownership to natural persons. While OCIE reported that the MMFs were in substantial compliance with the amended rules, they did note some deficiencies or weaknesses. These included those summarized below.

- Some MMFs failed to include in their credit files all of the factors required to be considered when determining whether a security presents minimal credit risks, failed to periodically update the credit files to support the eligible security determination, or failed to maintain records supporting determinations that investments in repurchase agreements with non-government entities were fully collateralized;
- Stress test results provided to boards in some instance failed to include the required summary of significant assumptions used in the stress tests;
- Some MMFs failed to adopt or implement compliance policies and procedures tailored to the Rule 2a-7 requirements relating to, testing for issuer diversification, filing Form N-MFP, limiting investors in Retail MMFs to natural persons, and imposing and lifting liquidity fees or gates, among other areas; and
- Certain MMFs failed to post information required by Rule 2a-7, or posted inaccurate information, on their website, while others failed to include all required legends in their advertising materials.

OCIE's Target Date Fund Initiative

OCIE also examined over 30 TDFs, including those managed to a target date and those managed through such date. The reviews focused on whether the TDFs' assets were invested according to the asset allocations stated in each fund's prospectus, and whether the actual investment risks were consistent with fund disclosures, including those made in marketing materials. Again, OCIE indicated that most TDFs appeared to be in general compliance with the 1940 Act, but that it did observe instances of deficiencies or weaknesses in the areas summarized below.

- OCIE observed incomplete and potentially misleading disclosures in prospectuses or advertisements relating to asset allocation or glide path information and discussions of conflicts of interest that may result from the use of affiliated funds and advisers; and
- Incomplete or missing policies and procedures for monitoring asset allocations, glide path changes and allocations, and advertising and sales literature.

As with all Risk Alerts, OCIE encourages all funds to review their policies and procedures, as well as their practices, in the areas discussed in the Risk Alert. Dorsey would be pleased to provide any assistance needed in this regard and will work with its clients to consider any improvements in their compliance programs as may be appropriate.